Farmers (ATG) Chapter Ten - Tobacco

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Tobacco Industry Background

The tobacco industry has a long history in the U.S. economy. It has been an important source of revenue for the Federal, State and local government. Over the past two decades, the tobacco industry experienced great upheavals, with the industry in a state of decline. The 2007 Census of Agriculture found that the number of tobacco farms decreased by 83% from 93,530 in 1997 to 16,234 in 2007. The decline can partially be attributed to the reduction in tobacco demand and consumption. Smoking restrictions, increased excise taxes, compliance with public health polices and FDA regulations are the major factors shaping the industry. Among all the factors, the termination of the federal tobacco quotas program in 2004 has had the greatest impact on tobacco farmers.

From 1938 to 2004, the tobacco industry operated under a government production control and price support system. The government regulated the tobacco production through acreage allotment and marketing quota. At the beginning of the tobacco season, each farmer was notified by the USDA-ASCS of how much tobacco he or she was allowed to plant and how much he or she was allowed to sell. If the farmer grew more than what's allowed by his or her quota, he or she would have to destroy the excess, sell the excess with a penalty or store it until the next year and sell it against the next year's quota. On the other hand, the government also regulated the prices to guarantee the farmer a fair price. A support price was established each year by the USDA using a preset formula. Even if the bid at the warehouse auction did not attain the support price, the farmer would still be compensated at the support price level by means of a loan from the government owned and operated Commodity Credit Corporation (CCC).

The government price support system mandates a market price much higher than the price of foreign produced tobacco. Over time, the demand for U.S. produced tobacco has sharply declined, with domestic and foreign buyers turning to non-U.S. suppliers. The U.S. tobacco production fell by forty eight percent from the early 1980s to the late 1990s and the U.S. tobacco exports decreased by twenty percent during the same period. Over a number of years, congress has worked on legislation to end the federal tobacco program and allow for U.S. tobacco farmers to compete in a free market. The compensation to the tobacco quota owners and producers for the transition period was also debated during this process.

In October, 2004, as part of the Jobs Creation Act of 2004, the Fair and Equitable Tobacco Reform Act of 2004 was signed into law. The Act is commonly referred to as the "tobacco quota buyout". The bill ended the 66 years of federal control of the U.S. tobacco production and sales. Beginning in 2005, there are no federal restrictions on where and how much tobacco can be produced. Price supports and quotas no longer exist. To help the farmers' transition to the free market, the buyout bill also provided approximately 10 billion dollars to eligible quota owners and producers. Payment is made over ten years and in ten equal annual payments. There are roughly 436,000 quota owners who would receive $7 per pound on their basis marketing quotas (totaling about $6.7 billion) and 57,000 producers would receive $3 per pound on their marketing quotas

(totaling $2.9 billion). The buyout is funded through the assessments of tobacco product manufactures and importers who are required to pay a quarterly assessment to a Tobacco Trust Fund for ten years.

Since the end of the federal tobacco program, the industry has seen many changes. Tobacco prices have plummeted, only to rebound so its prices are close to what they were before the tobacco quota buyout. For example, flue-cured tobacco, which accounts for 63% of U.S. total tobacco production, saw its price decline from $1.80 to $1.50 in 2005, but increased to about $1.75 in 2010. The same is not true with the production level. The production level for flue cured tobacco was 521.5 million pounds in 2004, decreasing to 380.8 million pounds in 2005 and increasing to only 453.1million pounds in 2010, still 13% below the 2004 level. The number of tobacco farms and farm acreage has also decreased substantially. Many small farmers exited the tobacco industry; while some have made the transition to farming other crops. The larger farms have expanded their operations to achieve better production efficiencies. The larger farms have used the tobacco buyout payments to invest in equipment, land and operations.

U.S. tobacco has performed well in the export market during the post buyout era. For example, the export of flue-cured tobacco has increased by more than fifty percent from 2004 to 2010. The fall of U.S. tobacco prices and weakening U.S. dollar helped the export increase. The United States, Brazil, China and India are the major tobacco producers in the world. Brazil is the main competitor to U.S. tobacco exports. U.S. tobacco is perceived to be a differentiated product by foreign purchasers for which they are willing to pay a premium price. Japan, Russia and the countries in the European Unions used to be the main importers of U.S. tobacco. The U.S. growers are also concentrating on developing new buyers in Asia, particularly China, and also in East European countries.

The domestic market for tobacco products has not improved as much as the export market in the post buyout era. One explanation is that the price differential between the U.S. tobacco and foreign tobacco has not narrowed enough to attract U.S. cigarette manufacturers. Another explanation is the declining U.S. tobacco consumption due to increased excise taxes and FDA regulations. The Federal excise tax increased from 24 cents per pack in 1995 to $1.01 per pack in 2009. The average State excise tax increased from 32.7 cents per pack to $1.20 per pack over the same period. In 2009, congress passed a bill restricting tobacco ads. The bill also allows the FDA to set the standard to lower nicotine content in cigarettes and to control pesticide chemical residuals in raw tobacco. The law also banned most tobacco flavorings which are considered as a lure to first time smokers. The taxes and the laws to regulate and discourage smoking have a continuous effect on the declining domestic tobacco market.

Like many other farming industries, the tobacco growers are also struggling with the increased cost in fuels, fertilizers and chemicals and the uncertainty in maintaining tobacco contracts with manufacturers. The free market provides the U.S. tobacco growers with both opportunities and challenges.

Tobacco Farms and Production

The 2007 Census of Agriculture counted 16,234 tobacco farms using 359,846 acres to grow tobacco. Tobacco farms produced 785 millions of pounds of tobacco and generated $1,268,114,000 revenue in 2007. The next Census is scheduled to be done in 2012. The United Stated Department of Agriculture (USDA) provides useful agriculture statistics and should be reviewed for current data at USDA National Agriculture Statistics Service.

Even though tobacco is grown in many states; North Carolina, Kentucky, Tennessee, Virginia, South Carolina, Georgia, and Pennsylvania are the top producers.

About the Plant

Tobacco plants are started with very small seeds planted in trays and cultivated in either greenhouse or well managed plant beds. Once the plants reach maturity in the greenhouse, they are transplanted to the field. The flowering stage is the first sign of maturity. At the reproductive or flowering stage, the plant will be "topped" to encourage the nutrients the plant absorbs to go towards the leaves and stalk of the plant. After the plant has been topped, it will be harvested for its leaves. The leaves are used in tobacco products such as cigarettes, snuff, cigars, and chewing tobacco. The majority of tobacco leaves are cured with one of the following three methods: (1) air-curing, (2) flue-curing, (3) fire-curing.

Each of these methods reduces the moisture content and enhances the color and aroma of the tobacco. The characteristic of the leaves, harvest, and curing method distinguish tobacco to different types. In the U.S., the most common tobacco types include burley, flue-cured, dark air, and dark fire. Burley and flue-cured tobacco account for ninety percent of total tobacco production in the U.S.

Burley tobacco is a light air-cured tobacco used primarily for cigarette production. Burley has broad leaves and is harvested on the stalk by hand. After the air-curing processes for four to eight weeks, it has a light brown to reddish brown color. According to the USDA data, Burley production accounted for twenty-six percent of the total U.S. tobacco production in 2010. It is primarily produced in Kentucky, Tennessee, and Pennsylvania. In 2009, it sold for $1.71 per pound.

Flue-cured tobacco is also primarily used for cigarette production. The leaves are usually harvested by machine. They are cured in the curing barns with heat distributed through metal pipes or flues. The cured leaves have an orange or yellow color. Flue-cured tobacco accounts for the majority of U.S. tobacco production. It is primarily produced in North Carolina, Virginia, South Carolina and Georgia. In 2009 it sold for $1.75 per pound.

Dark air tobacco is primarily used for chewing, snuff, cigar, and pipe blends. The plant produces heavier and larger leaves with a leathery texture and possesses a somewhat oily sheen. It is cured essentially the same as burley. Dark air tobacco consists of a very small

percentage of the total U.S. tobacco production. It is produced in Kentucky and Tennessee. In 2009 it sold for $2.24 per pound.

Dark fire tobacco is essentially the same as dark air tobacco, except that it is fire-cured. The controlled fires are built on the floor of the barn and the leaves cure in the smoke-filled barn. This process requires experience and skill to prevent ruining the tobacco. The dark fire tobacco consists of a small percentage of total U.S. tobacco production and sold for $2.47 per pound in 2009. It is produced in Kentucky, Tennessee and Virginia.

Production Cycle and Yield

Depending on the types of the tobacco produced, the production cycles are slightly different. Since most of the tobacco grown in the U.S. is either Burley or Flue-cured, the production cycle of these two types are discussed here in detail.

Burley Tobacco

Burley Tobacco season usually begins in March when seeds are planted in the greenhouse in large trays. It takes eight to ten weeks for the seed to germinate and cultivate in the greenhouse before it is ready to be planted in the field. In May, the young tobacco plants are planted in the field by machines. The growing season is approximately 100 days from May to August. In August, the plants are topped so that the nutrients will go to leaves rather than the flowers. Starting in August, the crops will be harvested by hand and the curing process begins. Burley tobacco production is labor intensive. It requires 150 to 200 hours of labor per acre, one third of which is used for harvesting. The harvested leaves are hung in well-ventilated barns and allowed to dry over a period of four to eight weeks. The market for trading burley tobaccos begins in November and closes in February of the next year.

Flue-cured Tobacco

Flue-cured tobacco season starts a bit earlier than burley tobacco. The greenhouse seeding and cultivation begins in February. In April and May, the crops are planted in the field. April through August is the growing season and the plants are usually topped in July. Between July and October, the crops are harvested and cured. Unlike burley tobacco, the flue-cured tobacco is harvested mechanically. The production for flue cured tobacco requires a little over 100 labor hours per acre. The curing process is handled in heated curing barns where the heated air from the flues forces the tobacco to dry. The market for trading flue-cured tobacco begins in September and closes in December.

Tobacco Revenue and Expenses

Tobacco used to be sold in warehouses through auctions and bidding process, but in 2001, auctions were replaced by annual contracts. Nowadays, over ninety percent of tobacco is grown under contract. The cigarette manufacturers, such as Philip Morris and

R.J. Reynolds, gain greater efficiency in buying leafs through contracts and more control over quality and grades. The high cost of growing tobacco and the uncertainty of the tobacco market deterred most farmers from growing tobacco without a contract.

Other than Philip Morris, Reynolds and Japan Tobacco International, many farmers also contract with leaf merchants and processors such as Universal Corporation. Other players in the buyers marketed include U.S. tobacco Cooperative and Burley Tobacco Growers Cooperative Association, both formerly involved in administering government price support program. Many of the buyers operate tobacco receiving stations and processing and marketing centers in the tobacco growing states.

Tobacco Contracts

While contracts offered by different companies vary, most contracts include provisions about quality, quantity, ownership, production standards, prices, payments, and enforcement.

The contract determines the poundage the farmer will grow. All contracts require that flue-cured tobacco be harvested in phases. The tobacco has 5 stalk positions: primings, lugs, cutters, leaf and tips. Primings, lugs and cutters are bottom-most leaves and the first to ripen. Contracts pay a larger price premium for high-quality bottom leaves. Almost all contracts require that tobacco be delivered in bales, with each bale having tobacco from one farm, of a single stalk position, weighing between 600 and 850 pounds and having a moisture level less than eighteen percent. Under the contract, the grower assumes all risk of loss and damage to the tobacco until the buyer accepts the tobacco at the agreed upon delivery station.

The grower makes an appointment to deliver the tobacco to the receiving station or marketing center operated by the manufacturer or leaf merchant throughout the country. All tobacco is weighed and graded the same day it is received. Prices for each grade are specified in the contract. The checks are made to the growers on the delivery date. Form 1099 is issued to the grower for the payments. Examiners should match the date of delivery with the check date and deposit date. This is done to verify the income is reported in the year received.

Income Probe

Interviews and the tour of farms are important to assess the income sources. The following paragraphs describe examples of other sources of income the examiner should be aware of and look for.

A grower can have contracts with more than one manufacturer. In addition, they may plant five to twenty percent over their contract to ensure they make their pounds. The extra production could be sold either to the co-op or to an auction. The examiner should

request all of the contracts in the examination year, question the actual production level and ask if any tobacco was sold to an auction or non-contract leaf buyers.

Even though tobacco is typically a highly profitable crop to grow (e.g. it is estimated that it takes 43 acres of cotton to yield an equivalent return of 10 acres of tobacco), a significant number of tobacco farmers also grow soybeans, corn and hay. Others raise cattle and grow greenhouse vegetables. Each year, farmers must complete FSA Form 578 at the local Farm Service Agency office for acreage certification to be eligible for certain USDA farm program benefits. The Form 578 contains the information of farm numbers, acreage and types of crops planted. The examiner can request a copy of FSA Form 578 to understand the operation of a particular farm.

Rental income can be another source of revenue to farmers. Farmers may rent out the farmland that they don't use. Some growers might have more curing barn capacity than they need. Some growers have been found to buy used equipment and rent it to other growers. Rental income from farmland, curing barns and equipment should be questioned at the initial interview.

Some farmers are engaged in the sale of tobacco seeds and plants. A farmer with large green houses and large purchases of seeds, trays and potting medium should be examined more closely for the possible income from the sale of seeds and plants.

Examiners should inquire about crop insurance proceeds, particularly when there has been a significant loss. Growers must include in income crop insurance proceeds received as a result of crop damage.

Interviews and tour of business are very important in assessing all potential income sources. The alternative method of using curing cost to estimate production level and revenue for flue-cured tobacco is discussed in the Curing Cost section.

Tobacco Farming Expenditures

The Center for Tobacco Grower Research has conducted a survey on the primary accounting systems used by tobacco growers. The following types of accounting systems were found to be used; handwritten journals, QuickBooks, Excel spreadsheets and other software or systems. It is not uncommon for personal and farming expenses to be commingled in a single checking account. Typically, a farmer operates on borrowed funds for a large part of the year to purchase seeds, fertilizer, fuel and pay laborers. Farmers usually do not earn crop income until they sell the products. The sale of tobacco proceeds are usually received and deposited into the bank between September and February of the next year.

Examiners who audit a tobacco farm will see large expenses in seeds, fertilizers, chemicals, fuel, labor, depreciation and repairs. Several State Universities publish an annual tobacco guide through their College of Agriculture or Cooperative Extension Services. The guide contains information on budget and estimated costs and returns per

acre. It also provides information on price and production outlooks and various aspects of tobacco growing. It is a good resource for the examiner to understand the production and to perform statistics analysis; but bear in mind that most farmers grow more than just tobacco and they may combine all expenses when reporting them on the tax return. Examiners can use the data as a bench mark for a comparative analysis.

These tobacco guides can easily be accessed through websites. The following is a list of Universities who publish a tobacco guide.

North Carolina State University Cooperative Extension Services
University of Kentucky College of Agriculture, Burley Tobacco Extension
University of Tennessee Institute of Agriculture
University of Tennessee Tobacco Production Info
Virginia Cooperative Extension of Virginia Tech and Virginia State University
University of Georgia, College of Agriculture and Environmental Science

The estimated costs vary across regions. This section will focus on a few major expenditures.

Chemicals

Like other crops, tobacco farming involves nutrient management, weed management, disease control and insect control. Most state departments of agriculture provide soil testing services for growers, generally for a small fee, to determine lime and nutrient needs to achieve the ideal PH level and the level of nutrients. It is important for a farm to develop a proper weed, disease and insect control system. Some growers hire service companies to apply crop protection chemicals of herbicides and pesticides. One important step in tobacco production involving chemicals is topping and suckering. This practice increases yield and is usually controlled through application of a chemical called maleic hydrazide (MH). The international guidelines on MH tolerance level is set at 80 parts per million. The U.S. growers are now required to comply. They could lose future contracts if their sampled tobacco does not meet the tolerance level. Tobacco buyers require growers to maintain accurate records of chemical application to the crops and the crops are subject to random sampling for chemical residue testing.

Fuel & Curing Costs

After harvesting, tobacco must be dried under controlled conditions (cured) before it can be sold or stored. Flue-cured tobacco is force-dried in bulk barns, using natural gas, propane, or liquefied petroleum gas (LP gas) as a heating fuel. LP gas is used by more than 80 percent of growers. Since barns hold a specific quantity of tobacco and use a specific quantity of fuel for a curing cycle, the examiner can estimate production level and the revenue based on the gallons of curing fuel used.

According to the fuel consumption data gathered by the North Carolina State University Cooperative Extension Service, the average curing efficiencies range from approximately

7.34 to 13.98 pounds of cured leaf per gallon of LP gas. The service recommends the growers to target an average curing efficiency of ten pounds per gallon. Their Cost Estimate Table suggests that to cure one acre of tobacco, it requires 275 gallons of fuel. If the fuel cost is at $1.30 per gallon, it will cost the grower $357.50 to cure one acre of tobacco.

To use curing cost as an indirect method for income analysis, the examiner should consider the curing efficiency and the fuel amount on hand at the beginning and the end of the season. The curing efficiencies are affected by such factors as barn condition, quality of the tobacco and curing management. Most experienced growers have a good idea how much cured tobacco they can expect from their barns, and if they have installed a gas meter on a single barn (which costs approximately $400), they can provide accurate information on fuel consumption. Examiners should ask the following questions related to the curing costs in the **interview**:

- How many acres of tobacco did you grow?
- How many barns did you use to cure your tobacco? Did you cure for anyone else? Did anyone else cure tobacco for you?
- When did you purchase and install the barns?
- How long did the curing process take to cure for each barn?
- How many pounds of finished tobacco do you yield from each run?
- How many gallons of fuel did you use to cure a barn of tobacco?
- What type of fuel did you use to cure your tobacco? Who were your suppliers?
- How many gallons of fuel did you purchase in the examination year? How many gallons of fuel on hand at the beginning and the end of the season?
- Did you buy fuel in bulk? If so, where was it stored?

The information gathered from these questions can be used to estimate production level and revenue. The result then can be compared to the contract volume and the actual revenue reported on the return. For example, if the taxpayer spent $25,000 on curing fuel, and if the average price per gallon is $1.30, they would have consumed 19,230 gallons of fuel in curing tobacco in the examination year. If their curing efficiency is determined to be ten pounds per gallon, the taxpayer would have produced 192,230 pounds of tobacco. This poundage can be compared to the contract pound to see if it is reasonable.

Equipment, Repairs and Depreciation

Most tobacco farmers will have a tractor, planter, tiller, curing barns and possibly a harvester and irrigation equipment on the fixed asset schedule. The curing barns are frequently lined side by side. Most farms have insurance policies on curing barns and structures. During the tour of business, the examiner should reconcile the equipment and buildings against the depreciation schedule and raise questions to determine if any assets were sold or major repairs were made.

For tobacco barns, an issue might arise as to whether a tobacco barn is entitled to treatment under IRC Section 179 and what is the applicable recovery period. In the tax

court case Hart v. Commissioner, T.C. Memo 1999-236, the court determined that the tobacco barn used for the taxpayer's burley production was a "building" under both the appearance test and the functional test. The barn satisfied the functional test because the employees used the barn on a full time and regular basis to prepare the tobacco for sale by stripping, grading, baling and boxing tobacco. The barn provided working space that was more than merely incidental to the function of the structure as a curing facility. The court also determined that the applicable recovery period for the tobacco barn is 20 years.

Labor

Labor is one of the most challenging and expensive inputs in tobacco production, accounting for over thirty percent of the production cost per acre. The majority of flue-cured growers report they use migrant labor. In contrast, the majority of burley growers use family members. This may be a structural difference in farm operations; flue-cured growers tend to have larger operations and higher cash flow, making the use of hired labor more economically feasible.

H-2A labor is an important source of labor for tobacco growers. The H-2A temporary agricultural program enables agricultural employers to bring nonimmigrant foreign workers to the U.S. to perform agricultural labor or services of a temporary or seasonal nature. Employers must file a labor certification application with the U.S. Department of Labor. The workers must be guaranteed employment for at least three-fourths of the hours in the work contract. Farmers also must provide transportation expenses for travel, housing, workers compensation insurance, tools and supplies to complete assigned work. Companies and institutions such as the North Carolina Growers Association provide services to bring immigrant laborers to farmers.

H-2A visa agricultural workers are exempt from U.S. Social Security and Medicare taxes and employers are not required to withhold federal income tax from compensation. The H-2A worker is eligible to obtain a Social Security Number (SSN). Foreign Agricultural Workers contains additional information on withholding and filing requirements for H-2A agricultural workers.

Some farmers may use the services of a crew leader. The crew leader provides farm labor and is considered the employer of the workers unless there is a written agreement stating the crew leader is an employee of the farmer. For the crew leader to be considered contract labor, they must furnish and pay the workers.

Tobacco Transition Payment Program

The Fair and Equitable Tobacco Reform Act of 2004 terminated the tobacco marketing quota program and the tobacco price support program. As a result, eligible tobacco quota holders and growers are provided compensation for the lost value of the quotas and related price support. Quota holders and growers entered into contracts with Commodity Credit Corporation (CCC) to receive payments in annual installments over a 10 year

period beginning in 2005 and ending September 20, 2014. CCC is a wholly owned government corporation created in 1933 to stabilize, protect and support farm income and prices. It is essentially a financing institution for United Stated Department of Agriculture (USDA). The program funded by CCC is administered by the USDA's Farm Service Agency (FSA).

The Tobacco Transition Payment Program (TTPP) payments have important income tax implications for tobacco quota holders and growers. The IRS published Notice 2005-57 to provide answers to frequently asked questions regarding the tax treatment of federal payments. The Notice 2005-57 modifies and supersedes Notice 2005-51. The payments to quota holders are generally taxed as capital gain income while the payments to tobacco growers are taxed as ordinary income subject to self-employment tax.

Tax Issues

Tobacco Growers

Tobacco growers receive $3 per pound for their marketing quotas in ten equal annual payments in 2005 through 2014. The tobacco marketing quota is the quantity of tobacco all domestic producers are permitted to market each year. Payments to tobacco growers are taxed as ordinary business income in the year they are received. They are also subject to self-employment tax.

CCC reports the annual installment payments made to tobacco growers on Form 1099-G for the actual amount received during the calendar year. Tobacco growers will generally report the payment as an Agricultural program payment on Schedule F. If the taxpayer is a landowner who does not materially participate in the operation or the management of the farm and is receiving the grower payment because his farm rental income is based on the tobacco grown by a tenant, the grower payment should be reported on Form 4835, Farm Rental Income and Expenses. Payments to growers generally represent self-employment income because they are to compensate for loss of income from reductions in tobacco quotas. Even if the taxpayer is not farming when he receives the payments, they are still included in self-employment earnings if they relate to the taxpayer's farm business (even though the farm business is temporarily inactive). See Publication 225, Farmer's Tax Guide.

Tobacco Quota Holders

Tobacco quota holders receive $7 per pound for their quotas in ten equal annual payments in 2005 through 2014. A tobacco quota is considered an interest in land (Section 1231 asset) because it is assigned to farms and attached to land. The payments are usually reported as installment sales including the capital gain reporting and imputed interest reporting.

Imputed Interest Reporting

CCC reports the gross proceeds of a tobacco quota contract on Form 1099-S, "Proceeds from Real Estate Transactions" in the year that the contract was entered into. Unlike tobacco growers, CCC does not report annual installment payments to tobacco quota holders, but reports imputed interest amounts yearly on either Form 1099-INT or Form 1099 OID. The taxpayer should report the yearly imputed interest on Schedule B.

- The imputed interest amount for contracts with a total value of $250,000 and under is calculated according to IRS Section 483 and reported yearly on Form 1099-INT.
- The imputed interest amount for contracts with a total value of $250,001 and over is calculated according to IRS Section 1274 and reported yearly on Form 1099-OID.
- If the total payments of the installment contract are $3,000 or less, there is no unstated interest to calculate or report.

Capital Gain Reporting

The taxable gain is the total amount received for the quota reduced by any amount treated as interest over the adjusted basis.

The adjusted basis of the tobacco holding quota is determined differently depending on how he or she obtained the quota.

- The basis of a quota derived from an original grant by the federal government is zero.
- The basis of a purchased quota is the purchase price. If the taxpayer acquired a quota with the purchase of land, part of the purchase price should be allocated to the quota based on its value and the value of the land.
- The basis of an inherited quota is generally the fair market value of the quota at the time of the decedent's death.
- The basis of a quota received as a gift is generally the same as the donor's basis. However, under certain circumstances, the basis is increased by the amount of gift tax paid. If the basis is greater than the fair market value of the quota at the time of the gift, the basis for determining loss is the fair market value.

The tobacco quota holder is required to reduce the basis of his tobacco quota by the following amounts.

- Deductions taken for amortization, depletion, or depreciation.
- Amounts previously deducted as a loss because of a reduction in the number of pounds of tobacco allowable under the quota.
- The entire cost of a purchased quota deducted in the earlier year (which reduces the basis to zero).

Whether the gain or loss is treated as ordinary or capital depends on how the tobacco quota holder (holder) used the quota.

- If the holder used the quota in the farming business or for investment purposes, any gain or loss is capital gain or loss.
- If the holder previously deducted the cost of acquiring quota, or amounts of depreciation or amounts to reflect a reduction in the quota pounds, the gain should be included as ordinary income.

The rules to establish basis are simple, but to determine the correct dollar amount for basis is not easy for many quota holders, especially if the quota holder did not maintain records for the acquisition. If no precise records were maintained, the quota holder owner must make a good faith effort to calculate a basis value from historical information relevant to the holder's situation. In the absence of adequate records or a good faith effort, the IRS default position is that the basis is zero and the entire payment is a taxable capital gain.

Farm Income Averaging

The tobacco payments do not qualify for farm income averaging because a tobacco quota is considered an interest in land.

Installment Sales Reporting

Most quota holders use the installment sale method to report gain.

Example

A tobacco grower entered into a $100,000 tobacco buyout contract with CCC in 2005 to receive a $10,000 installment payment over a 10 year period. The total imputed interest portion over the contract period is $13,444.97. In 2005, CCC reports $100,000 on Form 1099-S to the tobacco quota holder.

For the 2010 year, the holder received the annual payment of $10,000. The imputed interest amount reported on Form 1099-INT for 2010 is $1,725.18. The holder determined that the entire basis of his tobacco quotas is $20,000.

- $1,725.18 interest income should be reported on Schedule B. The remaining amount of $8,274.82 principle is used to compute capital gain.
- To calculate the capital gain, first determine the gross profit ratio. The total contract price of $100,000 minus the total imputed interest of $13,444.97 equals $86,555.03, the selling price. The basis is $20,000.
- To determine the gross profit ratio, first the basis of $20,000 is subtracted from the selling price of $86,555.03 equaling $66,555.03. Next divide the $66,555.03 by the selling price of $86,555.03. The result is a percentage of .7689, which is the profit ratio.
- The principle payment received is $8,274.82, multiplied by the profit ratio of .7689, resulting in $6,362.51 for installment sales income in 2010.
- The installment sale income from the tobacco payment is reported on Form 6252.

Lump-Sum Payment

The tobacco quota holder also had an option to report the entire amount of tobacco buyout income in 2005, making future payments tax free. The transaction should have been reported as a Section 1231 transaction on Form 4797.

The tobacco quota holder might also decide to sell the remaining installment payments to a financial institution in a later year. In this circumstance, only the amount received from the financial institution is taxable and the examiner should verify that the remaining basis is calculated correctly.

Like-Kind Exchange

Since the tobacco quota is an interest in land and a Section 1231 business asset, the quota holder is eligible for IRC Section 1031 like-kind exchange treatment of the buyout payments.

The process to a successful like-kind exchange involves a Qualified Intermediary (QI) to hold the funds received from the buyout payment so that the taxpayer does not have "constructive receipt" of the funds. It also involves a financial institution to pay a negotiated lump-sum amount to the quota holder in exchange for the right to future buy out payments. The quota holder needs to identify the replacement property and follow strict time limits to comply with IRC Section 1031. All the exchange processes should have been completed by March 15, 2006.

Qualifying exchange property includes:

- Farm land
- Timberland
- Bare land for investment purposes
- REIT that issues a common tenancy deed
- Rentals including Beach Condos
- Commercial real estate (Rental property, Strip Malls and Etc.)

Since the like-kind exchange process was completed in 2006, this transaction is not likely to be examined directly. However, a new issue arises when the taxpayer sells the replacement property in later years and calculates the capital gain. The tobacco quota holder deferred the tax consequences of the tobacco quota buyout proceeds through a like-kind exchange. When the new property is exchanged, the basis of the new property is the adjusted basis of the tobacco quota, not the tobacco quota buyout proceeds.